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09-4414-cv

Fezzani v. Bear, Stearns & Co.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 2010

N.Y.S.D. Case #  
99-cv-0793(PAC)

(Argued: April 6, 2011

Decided: May 7, 2013)

Docket No. 09-4414-cv

MOHAMMED FEZZANI, CIRENACA FOUNDATION, DR. VICTORIA BLANK, LESTER  
BLANK, JAMES BAILEY, JANE BAILEY, BAYDEL LTD., MARGARET BURGESS,  
PATRICK BURGESS, BOOTLESVILLE TRUST, and ADAM CUNG,  
Plaintiffs-Appellants,

v.

BEAR, STEARNS & CO. INC., BEAR STEARNS SECURITIES CORP., RICHARD  
HARRITON, MORRIS WOLFSON, ARIELLE WOLFSON, ABRAHAM WOLFSON, TOVIE  
WOLFSON, ANDERER ASSOCIATES, BOSTON PARTNERS, WOLFSON EQUITIES,  
TURNER SCHARER, CHAN SASHA FOUNDATION, UNITED CONGREGATION  
MESERAH, ISAAC DWECK, Individually and as Custodian for NATHAN  
DWECK, BARBARA DWECK, MORRIS I. DWECK, RALPH I. DWECK, JACK  
DWECK, FAHNESTOCK & CO. INC., BARRY GESSER, MICHAEL REITER, and  
APOLLO EQUITIES,  
Defendants-Appellees,

ARTHUR BRESSMAN, ANDREW BRESSMAN, RICHARD ACOSTA, GLENN O'HARE,  
JOSEPH SCANNI, BRETT HIRSCH, GARVEY FOX, MATTHEW HIRSCH, RICHARD  
SIMONE, CHARLES PLAIA, JOHN MCANDRIS, JACK WOLYNEZ, ROBERT  
GILBERT, FIRST HANOVER SECURITIES, INC., BANQUE AUDI SUISSE  
GENEVE, FOZIE FARKASH, RAWAI RAES, BASIL SHIBLAQ, IYAD SHIBLAQ,  
KEN STOKES, MILLO DWECK, BEATRICE DWECK, RICHARD DWECK, ISAAC B.  
DWECK, HANK DWECK, and DONALD & CO.,  
Defendants.\*

B e f o r e: WINTER, CABRANES, and LOHIER, Circuit Judges.

\*The Clerk of Court is directed to amend the caption to read as shown above.

1 Appeal from a dismissal by the United States District Court  
2 for the Southern District of New York (Paul A. Crotty, Judge), of  
3 a complaint alleging securities manipulation in violation of  
4 Section 10(b). We affirm in part and vacate and remand in part  
5 by opinion with respect to one group of defendants. We affirm in  
6 part and vacate and remand in part by summary order with respect  
7 to remaining defendants.

8 Judge Lohier concurs in part and dissents in part in a  
9 separate opinion.

10  
11 MAX FOLKENFLIK, Folkenflik & McGerity,  
12 New York, New York, for Plaintiffs-  
13 Appellants.  
14

15 KERRY A. DZIUBEK (Michael D. Schissel &  
16 Jonathan N. Francis, on the brief),  
17 Arnold & Porter LLP, New York, New York,  
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19 Co. Inc. and Bear Stearns Securities  
20 Corp.  
21

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24 New York, for Defendant-Appellee Richard  
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27 DONALD A. CORBETT (Ira Lee Sorkin &  
28 Daniel K. Roque, on the brief),  
29 Lowenstein Sandler PC, New York, New  
30 York, for Defendants-Appellees Morris  
31 Wolfson, Arielle Wolfson, Aaron Wolfson,  
32 Abraham Wolfson, Tovie Wolfson, Anderer  
33 Associates, Boston Partners, Wolfson  
34 Equities, Turner Scharer, Chan Sasha  
35 Foundation, and United Congregation  
36 Meserah.  
37  
38  
39

DONALD N. COHEN (Timothy E. Di Domenico, on the brief), Greenberg Traurig, LLP, New York, New York, for Defendants-Appellees Isaac R. Dweck, Individually and as Custodian for Nathan Dweck, Barbara Dweck, Morris I. Dweck, Ralph I. Dweck, and Jack Dweck.

THOMAS J. QUIGLEY (Christopher J. Paolella, on the brief), Winston & Strawn LLP, New York, New York, for Defendant-Appellee Fahnestock & Co., Inc.

STEPHEN WAGNER, Cohen Tauber Spievack & Wagner P.C., New York, New York, for Defendant-Appellee Michael Reiter.

No appearance by Barry Gesser or Apollo Equities.

WINTER, Circuit Judge:

Several individual investors appeal from Judge Crotty's dismissal of their complaint alleging securities fraud in violation of Section 10(b). We dispose of this appeal by both summary order and opinion. In the summary order issued simultaneously with this opinion, we affirm in part and vacate and remand in part with regard to most appellees. In this opinion, we affirm the dismissal of the federal claim and vacate and remand on the state law claim with regard to one group of appellees, principally Isaac R. Dweck.<sup>1</sup>

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<sup>1</sup> Isaac R. Dweck is sued individually and as a custodian for Nathan Dweck, Barbara Dweck, Morris I. Dweck, Ralph I. Dweck, and Jack Dweck. Although appellants refer broadly to "the Dwecks," their allegations regarding the Dwecks seem to involve only Isaac R. Dweck.

## 1 BACKGROUND

2 This litigation arises out of a fraudulent scheme engaged in  
3 by a now-defunct broker-dealer, A.R. Baron ("Baron"). Over the  
4 course of four years beginning in 1992, Baron defrauded customers  
5 of millions of dollars. As a result, Baron's former officers,  
6 directors, and key employees have been convicted of various  
7 crimes.

8 As pertinent here, and based on the complaint, the  
9 allegations of which we assume to be true, Baron's scheme used  
10 high-pressure sales campaigns involving "cold calls" to potential  
11 customers. The goal of the scheme was to induce the customers to  
12 purchase securities in initial public offerings of small, unknown  
13 companies with negligible profits. The salespeople would falsely  
14 represent that the stocks were the subject of an active, rising  
15 market, and the purchasers were led to believe that the prices  
16 they paid were set by trading in that arms-length market. In  
17 fact, the market was principally a series of artificial trades  
18 orchestrated by Baron designed to create a false appearance of  
19 volume and increasing price. Baron's scheme was a paradigmatic  
20 "pump and dump" scheme.

21 The scheme was in part furthered by "parking" stock with  
22 trusted Baron investors, including Dweck. "Parking" would  
23 involve placing stock in the investor's account while Baron  
24 retained the risk of loss by promising to buy back shares, if  
25 necessary, at a price that afforded the insider a guaranteed

1 profit. Based on Baron's salespeople's false representations of  
 2 trading volume and increasing stock prices inducing customers to  
 3 buy, Baron and its co-conspirators would sell their holdings at a  
 4 profit before the stock crashed.

5 Appellants do not allege a liquid, efficient market in the  
 6 securities. Rather, they allege that the only market for them  
 7 was based on artificial trading by Baron and others. See Pls.'  
 8 First Am. Compl. at 9 ¶ 17 ("[T]here was no real market for [the  
 9 manipulated securities] outside of Baron, and its customers, and  
 10 other brokers with whom it conspired. Because of the limited  
 11 public information available . . . (few, if any, were followed by  
 12 other brokerage firm analysts)[,] Baron brokers were able to  
 13 'box' the stock.").<sup>2</sup> Appellants alleged that Baron and Bear  
 14 Stearns, see infra note 4, falsely represented the securities

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<sup>2</sup> Doubt has been cast upon the ability of plaintiffs alleging manipulation of securities prices to prove the existence of an actual liquid, efficient market for the securities that have allegedly been manipulated. See Charles R. Korsmo, Mismatch: The Misuse of Market Efficiency in Market Manipulation Class Actions, 52 Wm. & Mary L. Rev. 1111, 1114-17, 1171 (2011); see also West v. Prudential Sec., Inc., 282 F.3d 935 (7th Cir. 2002). In a liquid, efficient market, current prices are publicly reported in real time. To affect those prices -- say, to create the appearance of a rising demand and price for a particular security -- the manipulator would have to buy all the shares offered by the tens of thousands, if not millions, of traders wanting to sell at the higher price with the manipulators having no hope of finding buyers at that higher price. The "pumping" would thus be enormously expensive and the "dumping" impossible. Because proving reliance in schemes like Baron's, involving salespeople's false representations of a market, is not a serious problem, the implications of these insights relate principally to class actions. There may thus be some merit to a modified presumption of reliance in market manipulation cases because reliance by investors on a misrepresentation of a price as being set by an active, arms-length market may be presumed. See Korsmo, supra, at 1171. We leave this issue for consideration by future panels but call to the reader's attention the cited discussions.

1 were trading in "an active, liquid, bona fide market," see Pls.'  
2 First Am. Compl. at 10 ¶ 21, 16 ¶¶ 40-41, and that appellants  
3 believed the price at which the securities were offered was that  
4 established by that public market rather than an artificial price  
5 established by Baron. The deception on which appellants relied,  
6 therefore, were statements by Baron's salespeople that the  
7 customers were buying at a price set by public market activity.

8 The complaint alleged that Dweck was one of Baron's  
9 principal investors, provided Baron with short-term cash  
10 infusions and financing for specific deals, and allowed Baron to  
11 park certain securities on particular occasions in his accounts  
12 at other broker-dealers. Dweck was rewarded with ownership in  
13 companies on a preferential basis and a guaranteed return on his  
14 parking arrangements as well. These acts undoubtedly facilitated  
15 Baron's frauds. The impact of Dweck's involvement is alleged to  
16 have been twofold. Parking by Dweck and others "creat[ed] a  
17 false impression in the minds of Baron customers of the value and  
18 liquidity of the 'parked' securities and induced Baron customers  
19 . . . to make investments based on Baron's illusion of trading  
20 activity," id. at 44 ¶ 131, while Dweck's provision of funds to  
21 Baron prolonged the firm's frauds. See id. at 18 ¶ 46 (noting  
22 the importance of collective action for the fraud to succeed);  
23 see also id. at 81 ¶ 251.

24 However, appellants' claims for damages do not contain  
25 discrete claims related to the prices paid for the particular

1 securities parked by Dweck at times they were trading. Rather,  
2 they seek to recover damages for all losses caused by Baron.  
3 While the complaint contains voluminous records of trades  
4 involving securities of various firms over extended periods of  
5 time, no attempt is made to connect particular trades in  
6 particular securities to Dweck's parking.

#### 7 DISCUSSION

8 As noted with regard to Dweck, the only legal claims in the  
9 complaint argued on this appeal are that: (i) his conduct  
10 involved market manipulation in violation of Section 10(b) and  
11 Rule 10b-5; and (ii) he aided and abetted, and conspired to  
12 commit, fraud under New York law. Also, appellants make no claim  
13 for recovery from Dweck for damages caused by parking particular  
14 securities but seek, like our dissenting colleague, to impose  
15 liability on Dweck for all of Baron's deceptive activities.

16 We review de novo a district court's dismissal of a  
17 complaint for failure to state a claim under Rule 12(b)(6).  
18 Selevan v. N.Y. Thruway Auth., 584 F.3d 82, 88 (2d Cir. 2009).  
19 "In conducting this review, we assume all 'well-pleaded factual  
20 allegations' to be true, and 'determine whether they plausibly  
21 give rise to an entitlement to relief.'" Id. (quoting Ashcroft  
22 v. Iqbal, 556 U.S. 662, 679 (2009)). A complaint alleging  
23 securities fraud in a private action for damages is subject to  
24 heightened pleadings standards. First, it must satisfy Rule  
25 9(b), which requires that "a party must state with particularity

1 the circumstances constituting fraud or mistake." Fed. R. Civ.  
2 P. 9(b). Second, under the pleading standards of the Private  
3 Securities Litigation Reform Act, codified at 15 U.S.C. §  
4 78u-4(b), the allegations of the state of mind required for a  
5 Section 10(b) violation -- scienter or recklessness, Ganino v.  
6 Citizens Utils. Co., 228 F.3d 154, 168-69 (2d Cir. 2000) -- must  
7 state "facts [either] (1) showing that the defendants had both  
8 motive and opportunity to commit the fraud or (2) constituting  
9 strong circumstantial evidence of conscious misbehavior or  
10 recklessness." ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d  
11 87, 99 (2d Cir. 2007).

12 Valid securities-manipulation claims under Section 10(b)  
13 must allege: "(1) manipulative acts; (2) damage; (3) caused by  
14 reliance on an assumption of an efficient market free of  
15 manipulation; (4) scienter; (5) in connection with the purchase  
16 or sale of securities; (6) furthered by the defendant's use of  
17 the mails or any facility of a national securities exchange."  
18 Id. at 101. These elements -- save for the requirement of  
19 manipulative acts and a misplaced belief in the price of the  
20 security as being set by arms-length, bona fide trading<sup>3</sup> -- are,  
21 of course, identical to Section 10(b) claims generally. See

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<sup>3</sup> We do not read ATSI's reference to "reliance on an assumption of an efficient market free of manipulation" as referring to a liquid, efficient market with prices publicly reported in real time. We read ATSI's reference to an "efficient" market to mean only a bona fide "market free of manipulation." 493 F.3d at 101; see also supra note 2.

1 Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, 552 U.S.  
2 148, 156-57 (2008) (noting that the typical § 10(b) claim must  
3 make the same allegations).

4 There is no doubt that appellants have alleged a valid  
5 Section 10(b) claim against Baron based on false representations  
6 that the price Baron charged customers for securities was  
7 established in a market independent of artificial trading by  
8 Baron itself. They have also adequately alleged their reliance  
9 upon Baron's misrepresentations.

10 Our difficulty with regard to Dweck's liability under  
11 Section 10(b) arises from the lack of an allegation that Dweck  
12 was involved in any communication with any of the appellants.  
13 Dweck is alleged to have been one of a group that engaged in  
14 phony trading activity that created an "impression" of "value and  
15 liquidity" in securities being pedaled by Baron. There is no  
16 allegation that any appellant was told of Dweck's artificial  
17 trading, or purchased such securities in specific reliance on  
18 such trading. See Pls.' First Am. Compl. at 18 ¶ 46 (noting the  
19 importance of collective action for perpetrating the fraud); see  
20 also id. at 107 ¶ 332 (alleging reliance on defendants  
21 collectively and not individually). Baron and Bear Stearns<sup>4</sup> are

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<sup>4</sup> Bear Stearns' role in reporting the prices of Baron securities is unclear in the allegations of the complaint. The complaint states that Bear Stearns, acting as a clearing broker for Baron, sent confirmations of transactions, which may have contained information as to the prices paid by the particular investor. See Pls.' First Am. Compl. at 16-17 ¶ 42. Because confirmations came after trades were made, the price information was the result, not the cause, of the fraud. Plaintiffs also allege that Bear Stearns

1 the sole sources alleged regarding the appellants' perceptions of  
2 prices at which trades were being made.

3 Dweck is sufficiently alleged to have had particular  
4 knowledge of some artificial trades, to have participated in  
5 them, and to have actively facilitated Baron's fraudulent  
6 business generally by loans and other investments. The issue is  
7 whether, as appellants argue and our dissenting colleague agrees,  
8 these allegations sufficiently support a Section 10(b) claim for  
9 damages by all the appellants for all the fraudulent sales of  
10 securities to them by Baron.

11 In pursuing a claim against Dweck for all damages caused by  
12 Baron, appellants make no claim of Dweck's liability under  
13 respondeat superior or other common law theory of vicarious  
14 liability. They have also abandoned any claim on appeal that  
15 Dweck is liable under Section 20(a) as a "controlling person" --  
16 any "person who, directly or indirectly, controls any person  
17 liable under [the '34 Act]" is "liable jointly and severally" for  
18 the violation, 15 U.S.C. § 78t(a) -- with regard to Baron's  
19 fraud. And, they have dropped all claims based on Section 9 of  
20 the '34 Act. 15 U.S.C. § 78i (prohibiting "any transaction"

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issued monthly statements to investors, which may have contained information as to current value based on share price. Id. The values reported, if reported, in the monthly statements, would have been derived from reports of traders by the brokers used by the manipulators, in Dweck's case, Fahnestock & Co, Inc. See id. at 59-60 ¶ 178 (suggesting that brokers book trades on behalf of their clients); id. at 44 ¶ 130 (stating that Baron was responsible for booking the parking transactions and placing shares in customer account).

1 effected for "the purpose of creating a false or misleading  
 2 appearance of active trading in any security . . . or a false or  
 3 misleading appearance with respect to the market for any such  
 4 security").<sup>5</sup>

5 Therefore, because there is no aiding and abetting liability  
 6 in private actions under Section 10(b), Dweck may be liable in  
 7 this matter only as a primary violator. Cent. Bank of Denver  
 8 N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 180,  
 9 191 (1994). The Supreme Court has held that to prove a primary  
 10 violation of Section 10(b), in such a private action, a plaintiff  
 11 must allege that the specific defendant was identified as making  
 12 the pertinent misrepresentation(s). Stoneridge, 552 U.S. at 158-  
 13 59. Otherwise, the plaintiff's complaint would fail to allege  
 14 reliance upon a misrepresentation made by that defendant, an  
 15 element of a valid Section 10(b) claim for damages caused by a  
 16 primary violator of that section. In short, an allegation of  
 17 acts facilitating or even indispensable to a fraud is not  
 18 sufficient to state a claim if those acts were not the particular

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<sup>5</sup> At the time this action was filed, and indeed for much of the period during which it has been litigated, Section 9 of the Securities and Exchange Act prohibited, and provided a remedy for those who were injured as a result of, certain manipulative conduct in the trading of securities traded on "national securities exchanges." See, e.g., 15 U.S.C. § 78i(2006). Plaintiffs' Section 9 claim, asserted in a prior iteration of the complaint, was dismissed by the district court as a result of that particular then in-force limitation. See Fezzani v. Bear, Stearns & Co., 384 F. Supp. 2d 618, 641 (S.D.N.Y. 2004). The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, significantly amended Section 9 by, among other changes, removing the "registered on a national securities exchange" limitation. Section 9, on its face, now covers manipulative conduct in the trading of most securities.

1 misrepresentations that deceived the investor. See, e.g., id. at  
2 157-59.

3 For example, in Stoneridge, the defendant, Scientific-  
4 Atlanta, had knowingly structured a sale of cable boxes to  
5 Charter at an artificially high price. Id. at 154. At the end  
6 of the year, Scientific-Atlanta returned the excess portion of  
7 the price by purchasing advertising from Charter at above-market  
8 prices. Id. at 154-55. This was alleged to have been a phony  
9 transaction designed only to allow Charter to report the returned  
10 excess as a purchase of advertising by Scientific-Atlanta, thus  
11 inflating Charter's revenue, and then to capitalize the inflated  
12 costs of the cable boxes, thereby decreasing Charter's apparent  
13 operating costs. Id. Although the complaint in Stoneridge  
14 alleged that the transactions had no economic substance and were  
15 specifically intended by Scientific-Atlanta to deceive investors  
16 (and Charter's auditor) -- precisely as appellants have alleged  
17 with regard to Dweck's acts -- the Supreme Court held that  
18 Scientific-Atlanta could not be liable in a civil action for  
19 damages under Section 10(b). Id. at 154-55, 166-67. The ground  
20 for this holding was that only Charter, and not Scientific-  
21 Atlanta, had made the fraudulent statements to the public through  
22 its financial statements. Id. at 155, 166-67.

23 The Supreme Court further elaborated this test in Janus  
24 Capital Grp., Inc. v. First Derivative Traders, 564 U.S. \_\_\_, 131  
25 S. Ct. 2296 (2011). In Janus, the Court held that a corporation

1 serving as the investment advisor and administrator  
2 -- the manager -- of a mutual fund could not be liable under  
3 Section 10(b) for false statements made in the mutual fund's  
4 prospectuses. Id. at 2299, 2305. The Court held that the  
5 advisor/administrator was insulated from Section 10(b) civil  
6 liability because the false statements to the public were made  
7 only in the name of the mutual fund, a separate corporate entity.  
8 Id. at 2305. Given that the advisor/administrator, as the Fund's  
9 manager, had surely prepared the prospectuses, Dweck's more  
10 limited involvement in Baron's frauds, although serious, is  
11 foreclosed by Janus (and Stoneridge as well).

12 Applying these principles to the present claims, appellants  
13 were required to allege acts by Dweck that amounted to more than  
14 knowingly participating in, or facilitating, Baron's fraud to  
15 state a claim under Section 10(b). To reiterate, under ATSI,  
16 manipulation violates Section 10(b) when an artificial or phony  
17 price of a security is communicated to persons who, in reliance  
18 upon a misrepresentation that the price was set by market forces,  
19 purchase the securities. 493 F.3d at 101-02. Under Stoneridge,  
20 552 U.S. at 159-60, 166-67, and Janus, 131 S. Ct. at 2305, only  
21 the person who communicates the misrepresentation is liable in  
22 private actions under Section 10(b). The present complaint  
23 alleges only that Baron and Bear Stearns communicated the  
24 artificial price information to the would-be buyers. Therefore,  
25 allegations of financing Baron's operations and parking some

1 securities fail to state a Section 10(b) private claim for  
2 damages against Dweck.

3 To summarize, appellants have sufficiently pleaded with  
4 particularity that Dweck provided knowing and substantial  
5 assistance in financing and facilitating the Baron fraud. While  
6 such allegations would easily be sufficient in an SEC civil  
7 action, see 15 U.S.C. § 78t(e), or a federal criminal action  
8 because this knowing and substantial assistance constitutes, at  
9 the least, aiding and abetting, see 18 U.S.C. § 2, they do not  
10 meet the standards for private damage actions under Section  
11 10(b).

12 Nevertheless, with regard to appellants' state law claims --  
13 civil conspiracy to defraud and aiding and abetting fraud -- the  
14 complaint alleges sufficient involvement by Dweck in the scheme  
15 to survive a motion to dismiss. Therefore, we vacate the  
16 dismissal and remand appellants' state law claims against Dweck  
17 for further proceedings.<sup>6</sup>

18 CONCLUSION

19 We therefore affirm the district court's dismissal of  
20 appellants' federal securities claims against Dweck and vacate  
21 and remand the state law claims.

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<sup>6</sup> It is appropriate for the district court to retain jurisdiction over these state claims for the reasons expressed in its earlier opinion, that is, because these state law claims arose out of the same set of facts as the federal claims. See Fezzani v. Bear, Stearns & Co., 592 F. Supp. 2d 410, 429-30 (S.D.N.Y. 2008).

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Catherine O'Hagan Wolfe, Clerk

United States Court of Appeals, Second Circuit

Catherine O'Hagan Wolfe